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A primer on the evolution of Takaful

With the expanding demographics of Islamic countries and that of the Islamic population globally, the prospect of Islamic Insurance models looks promising. During 2007-2008, the emerging markets contributed close to 28% of the global economic activities. The Islamic countries on their own accounted for 23% of the emerging market's GDP and 11% of the premiums written in these economies (source: Sigma No 5/2008, Swiss Re).

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Emergence and Significance of Islamic Insurance

The beginning of the 20th century had Islamic scholars debating if conventional insurance was permissible under the Islamic principles of Sharia. The Takaful system of insurance, an alternative form in compliance with Sharia, was established in 1985 by the Grand Counsel of Islamic scholars in Makkah, Saudi Arabia, Shariah seeks to ensure that contracts governing insurance transactions are fair and just and in sync with social standards and the principles defined in the Koran. This conflict exists not with the concept of insurance but with a few factors that are inherent to the trading terms of conventional insurance contracts, namely:

- ***Gharar*** (uncertainty and misleading terms in contracts)
- ***Maisir*** (excessive risk taking, speculation)
- ***Riba*** (charging and receiving interest)
- ***Haram*** (investment in forbidden activities and goods, i.e. gambling)

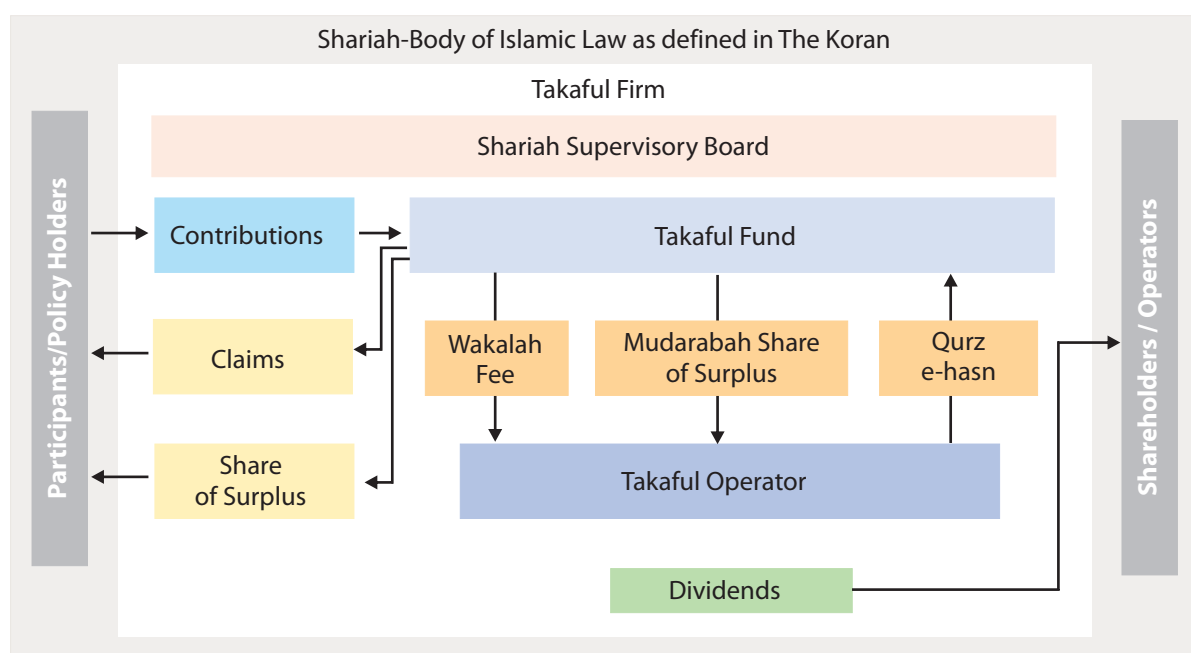



Fig 1: Takaful Insurance Model

The past two decades saw the evolution of a number of Islamic-compliant insurance forms (including Takaful), however, most of them lost credence over time, while Takaful emerged as a significant and popular form. Islamic scholars further agree that Takaful insurance, based on certain 'tijari' principles ensures that insurance contracts governed by Takaful are compliant to the principles of Al-Mudharabah or Al-Wakalah, which are the two main Islamic insurance business models. Takaful principles allow for the advancement of "a loan without interest" from the invested amount, "qurz-e-hasn", to any one of the insured at the time of need.

Emerging Opportunities in Islamic Insurance

Contrasts and Synergies

In the Wakalah model, insurance providers are assured of a fixed share of contributions as revenue while the Mudharabah model encourages efficient underwriting and investments for generating surplus funds, of which insurers receive a share.

There also exists a hybrid model which combines the principles of both Al-Mudharabah and Al-Wakalah models. Here the agent who is the Takaful intermediary receives both a predetermined share of the contributions paid by policy holders in the form of Wakalah fees as well a share of the profits generated from investment activities of the Takaful fund.

Under the ***Waqf*** model, agents make an initial contribution to a Waqf fund. An additional contribution collected from policy holders of the fund helps meet contingencies. Here also the underwriting agent receives a Wakalah fee and the surplus funds remaining after settlement of all outstanding claims, are distributed to the policy holders.

Implementation models of Takaful vary across companies and markets; the primary reason being that Sharia provides a guideline for the way the insurance business is conducted as opposed to strictures. The interpretation of the Sharia may vary slightly depending on the views and beliefs of those comprising the Sharia Supervisory Board.

At this point, we would like to point out that the operating model of a Takaful insurer is not very different from that of conventional insurance companies. The key differentiator is the segregation of the Shareholder's Fund and the Participant's Fund and the compliance to Shariah.

Re-takaful or Islamic Reinsurance Model

Reinsurance of the Takaful business on Islamic principles is known as Retakaful. Due to the acute shortage of Retakaful insurers in the market, for now, Sharia scholars allow existing operators to reinsure using conventional principles. Takaful companies also actively promote co-insurance with their competitors to supplement their underwriting capacity. Additionally, large, conventional reinsurance companies in Islamic countries accept retrocession.

Current Trends and Future Prospects

With the expanding demographics of Islamic countries and that of the Islamic population globally, the prospect of Islamic Insurance models looks promising. During 2007-2008, the emerging markets contributed close to 28% of the global economic activities. The Islamic countries on their own accounted for 23% of the emerging market's GDP and 11% of the premiums written in these economies (source: Sigma No 5/2008, Swiss Re). The amount of Takaful premiums from emerging markets was USD 1.7 billion, with Malaysia and Saudi Arabia showing the highest growth rates. However, other insurers operating on hybrid models with their base in the Sharia accounted for another USD 4 billion in premiums.

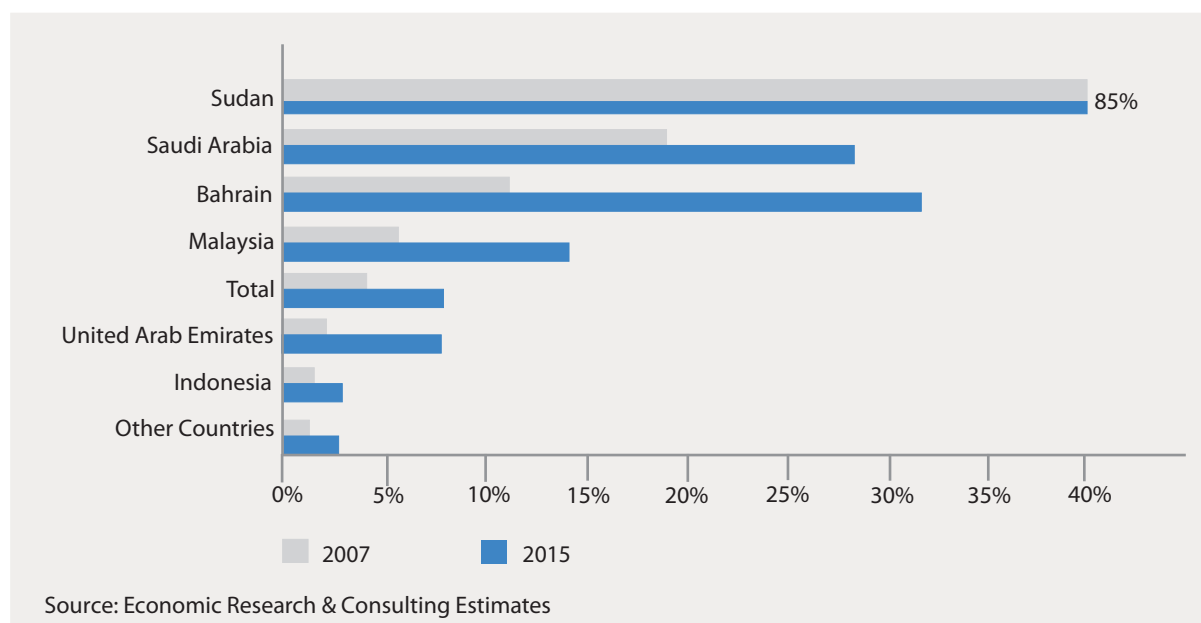
During the same period, the ratio of written premiums to GDP in Islamic countries is 1.3% of the GDP as compared to 2.8% for emerging markets as a whole. Therefore, the potential for Takaful operators to grow in these economies is tremendous. Current research points out that the market is grossly underserved with a balanced outlook for a year-on-year growth of 25% (after adjustment of inflation) for the next 3-4 years.

The Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) has been playing a key role in framing and reviewing the regulatory standards governing Islamic insurance companies. Although it frames the guidelines, the responsibility of the interpretation and implementation of these regulatory guidelines is governed by the Sharia Supervisory Board of each Takaful company.

With the improved standards of living and increasing awareness of Takaful, the market is expected to see steady growth in per capita spend on Takaful insurance premiums and also in terms of market share in comparison with conventional insurance products.

The Takaful industry has seen the entry of operators who can be categorized as:

- Local companies with home-grown solutions
- Local companies with IT solutions procured from established vendors
- Global players with a local front-end of their enterprise-level IT platform

Source: Economic Research & Consulting Estimates

Takaful market share is estimated to grow by 8% by 2015, from the current 4%, in Islamic countries

Product Portfolio

A large portfolio of Takaful products is being offered in the market by Takaful companies and is categorized as follows:

Motor – Third-party liability & comprehensive motor insurance for both individual and commercial markets. Other ancillary services being offered include road, personal accident insurance, among others.

Marine - Marine cargo, hull, liabilities and freight forwarders

Engineering - Erection all risks, contractors' all risks, plant and machinery, loss of profits and deterioration of stock

Property & Casualty - Fire and allied perils, property all risks, public liability, product liability, professional indemnity, medical malpractice

Miscellaneous – Money insurance, fidelity guarantee, workmen's compensation, employer's liability, traveler's insurance, personal accident

Specialty lines - Including bankers' blanket bond, jewelers' block, directors and officers insurance

Family Takaful

Life & Health – Includes group family Takaful (group life), personal accident & sickness benefits, group health insurance, medical & travel assistance benefits

The future will see growth in areas such as term assurance, mortgage protection or old-age annuities. Introduction of Takaful products to cater to these lines has been slow so far. To some extent, the complexity in the management of such portfolios, coupled with the lack of Takaful compliant IT solutions has kept operators at bay. In order to be successful and profitable, it is imperative for a Takaful company to offer a wide range of products and broad base their product lines.

Strategic Issues and Challenges

With projected growth as described in the previous sections, the Takaful industry will experience much change. As with all new product offerings, success will depend on several factors, both internal and external. Highlighted below are a number of strategic issues and challenges that providers will contend with as the industry expands.

Standardization

The global Takaful industry, currently, includes different operational models, accounting standards and regulatory regimes. Bahrain, Malaysia and Pakistan are currently the only markets to have issued specific Takaful laws or regulations. However, in spite of the laudable efforts by AAOIFI, the industry is still wanting in building a set of global regulatory standards that will be binding on all operators, with certain localizations.

Distribution Challenges

The Takaful industry is dominated by local operators. New entrants should create synergies that can be used to leverage existing distribution channels, banc-Takaful and strategic alliances across geographies. This will also enable the operators to increase premium volumes to improve profitability; a key factor in surviving the 'start-up' years.

Developing Innovative Products

Developing attractive and competitive products that meet diverse customer needs will be a major challenge for Takaful producers. Though Takaful providers cater to a very specific and presently unsatisfied market, they still need to create product offerings that are as sophisticated and innovative as their conventional competitors. Their ability to design products that exceed the standards presently set by conventional insurers will be the ultimate test for Takaful as a product.

Improving Marketing and Branding Tactics

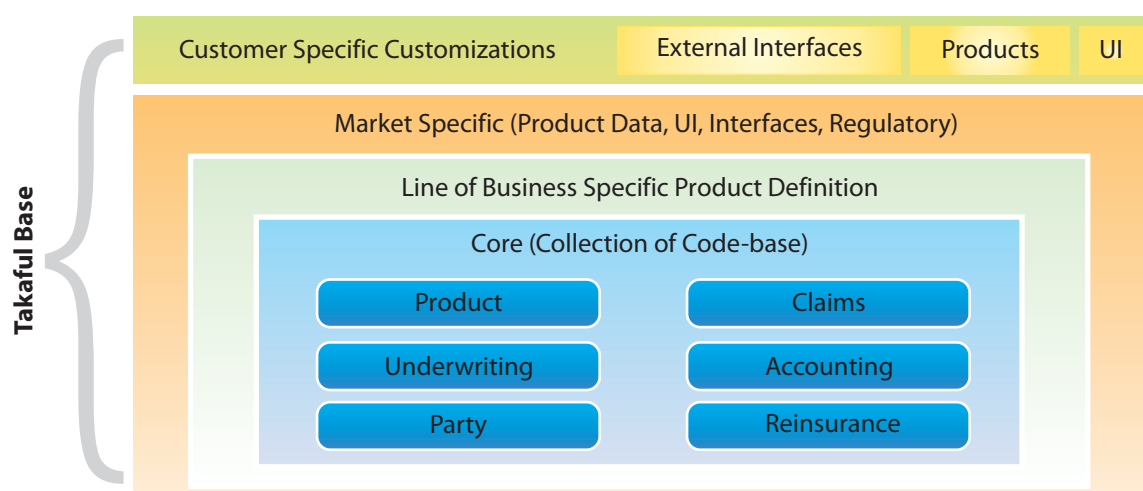
The present brand value of Takaful is relatively limited particularly in non-Islamic countries. Analysts have suggested that Takaful has enormous potential for Islamic and non-Islamic populations, offering an 'ethical' insurance alternative. Experts also propose that Takaful can potentially be a useful mechanism for poverty alleviation. The low penetration of insurance in many Islamic countries where Takaful operators are expected to be most successful indicates that Takaful operators have yet to make significant progress towards this end.

Raising the Standards in Customer Service

As the industry grows and becomes more competitive, building customer service skills and developing best practices will become increasingly important. At present, general customer service standards are average among Takaful providers, relative to their conventional counterparts.

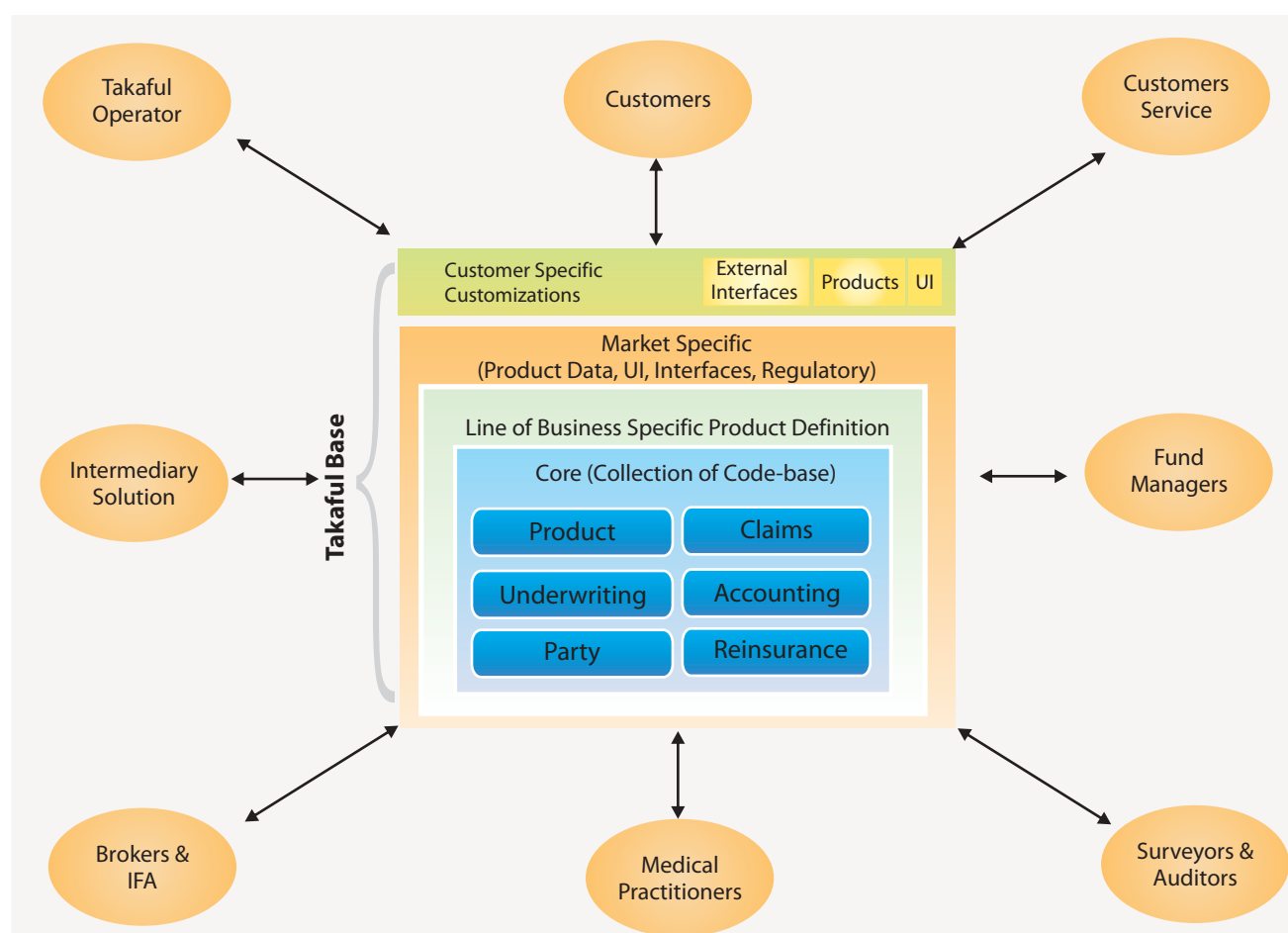
IT Solutions for Takaful

Issues such as innovative product development, time to market, servicing of policies and claims within acceptable time lines, accuracy of calculations, cost containment, and improvement in service standards can all be facilitated by the implementation of robust and flexible IT solutions. Takaful compliant IT solutions serve an important purpose from a regulatory compliance standpoint and can help operators avoid susceptibility to unfavorable regulatory decisions and the possibility of increased regulatory compliance costs.

A solution encompassing best practices from the industry acts as an enabler for Takaful operations.

The Takaful base for an insurance system should ideally offer the following capabilities:

- A rule-based Product Workbench, providing the ability to configure Sharia compliant products.
- A configurable, customer-centric claims management module for Takaful operations.
- Underwriting and Automated Risk Assessment to reduce underwriting poor risk.
- Takaful Accounting, accommodating Al-Mudharabah or Al-Wakalah based structure for operators.
- The Party component maintaining all stakeholders including policyholder, prospect, third parties, service providers, and organization structure, among others, with emphasis on role-based functions and properties associated with stakeholders.
- Reinsurance Module, to foster automation in the areas of accumulation, cession among reinsurance partners and claims apportionment, each of which can significantly improve back-office efficiency.

Portals for Stakeholders

A typical insurance solution offers its own user interface. Such an interface, however, forces a strait-jacket on stakeholders who have been offered application access through the security module. Web-service access to content-rich portals can enhance user experience. An Intermediary Solution is an application, which may be hosted by the insurer or sales force on their laptops and offers illustration and e-insurance advice capability.

Key Benefits From a Technology Solution

Speed-to-market and flexibility: An IT solution would have to be flexible in that it allows for the easy adoption of changes in business models, products and processes. Further, it should allow business users introduce new products, and define rates, exceptions in a manner that allows them to meet their business demands faster.

Complete functional coverage: The solution should cover all aspects of the insurance segment, with built-in components for product, party, underwriting and policy administration, claims management, accounting and reinsurance. Further, multilingual and multi-currency solutions will ensure wider usage across global markets.

Multi-channel delivery: With a layered architecture, the solution can support multiple delivery mechanisms and devices. It is possible to deliver the same services across intranet, internet (self-service) as well as through remotely connected and disconnected devices. This reduces time involved in aligning multiple channels for similar services to customers.

Easy integration: The solution must be highly scalable, enabling optimization of infrastructure and support costs, flexibility of deployment options and ease of integration with third-party systems. It should also support interfaces at the service level as well as the data level.

Enhanced operational efficiency: A solution that offers all of the above mentioned features will increase delivery speeds, eliminate paperwork, manual errors and administration redundancies, thereby, allowing for efficient workflows.

About TCS Financial Solutions

TCS Financial Solutions is a strategic business unit of Tata Consultancy Services. Dedicated to providing business application solutions to financial institutions globally, TCS Financial Solutions has compiled a comprehensive product portfolio under the brand name of TCS BaNCS With a global customer base in excess of 240 institutions operating in over 80 countries.

For more information, visit: www.tcs.com/bancs

About Tata Consultancy Services (TCS)

Tata Consultancy Services Limited is an IT services, business solutions and outsourcing organization that delivers real results to global businesses, ensuring a level of certainty no other firm can match. TCS offers a consulting-led, integrated portfolio of IT and IT-enabled services delivered through its unique Global Network Delivery Model™, recognized as the benchmark of excellence in software development.

A part of the Tata Group, India's largest industrial conglomerate, TCS has over 100,000 of the world's best trained IT consultants in 50 countries. The company generated consolidated revenues of US $5.7 billion for fiscal year ended 31 March 2008 and is listed on the National Stock Exchange and Bombay Stock Exchange in India. For more information, visit us at www.tcs.com

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